IN THE

Supreme Court of the United States

No. 660

MOLINE PROPERTIES, INC.,

Petitioner,

vs.

GUY T. HELVERING, Commissioner of Internal Revenue,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT.

REPLY BRIEF FOR PETITIONER.

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To the Honorable Chief Justice and Associate Justices of the United States Supreme Court:

The statement of the "question presented" appearing in respondent's brief makes an assumption that is misleading. The question is not "whether the profits realized by the taxpayer corporation" should be included in the corporation's or the stockholder's gross income; the question is whether the profits were those of the taxpayer or of the stockholder. The concept embodied in respondent's statement of the "question presented" pervades a large

part of respondent's argument. Thus respondent at the outset of his argument treats the real estate as "owned by the corporation," and discusses the case as if the issue were whether the corporation, the petitioner herein, is "exempt" from the corporation income tax levied by Section 13 of the two revenue acts here involved. (Brief, p. 9.) It is said (*ibid*) that the issue "is whether the taxpayer may be subject to any tax under this section." If by this statement it is intended that the issue is whether on the facts any tax is due and owing by the petitioner corporation, the statement is correct; but if, as much of the succeeding argument suggests, it is intended to imply that the issue is whether the petitioner is in any event subject to the tax imposed by Section 13 or is exempt from that tax, then the manner of statement is incorrect and does not properly set out the substance of what constitutes the issue.

It is not contended, as suggested (Brief, p. 10), that Congress intended to exempt corporations "where their activity is limited and they have but one stockholder." The suggested distinction, under the capital stock tax provisions, between corporations engaged in business and those not in business is beside the point. A corporation, though but an agent, may still be "doing business" within the meaning of the capital stock tax laws. For example, a corporation engaged in the business of acting as trustee for others is "doing business" by the mere act of the performance of the trust function. It is of course taxable on income which it beneficially receives, as, for example, from fees for its services. But no one would contend that a corporate trustee, or agent, was, by virtue of the circumstance of its being a corporation and therefore subject to Section 13, also required to pay an income tax on gains in respect of property held by it in trust. This is true even if legal title is held by the trustee corporation and there is nothing in the record to indicate that its legal

title does not also include the beneficial ownership. It would not be contended in such a situation that because treatment of the trustee holder of the record title "eases the task of administration" the realities should be ignored and the trustee subjected to a tax upon gain which beneficially belonged to the *cestui que trust*.

It may be conceded that "one of the prices of a corporation is payment of the federal tax on the corporate income." (Brief, p. 14) This does not reach the question as to what constitutes the "corporate income." The suggestion (*ibid*, footnote) that Congress has made provision for certain situations in which it "has dictated that the corporate veil be pierced" is also irrelevant to a determination of the actual relationship between two legal entities. Although the problem in this type of case is sometimes characterized as one of determining whether or not there should be a "piercing of the corporate veil" or "disregard of the corporate entity," what is really involved is a determination whether some circumstance, such as fraud, estoppel, the rights and liabilities of the parties as between themselves, the relation of agency, or some other circumstance, precludes a result which might otherwise follow. Thus in the present case the question is whether or not the land was beneficially owned by Thompson. If it was, then the gains from its sale were Thompson's. The answer of the Board of Tax Appeals to this question is that Thompson was the beneficial owner.

Respondent refers (Brief, p. 15) to *Southern Pacific Company* v. *Lowe*, 247 U. S. 330, 38 S. Ct. 540, 62 L. Ed. 1142, and *Gulf Oil Corporation* v. *Lewellyn*, 248 U. S. 71, 39 S. Ct. 35, 63 L. Ed. 133, and then urges the distinction that these cases had to do with the question whether post-1913 dividends of the taxpayer which arose from the pre-1913 income of subsidiaries were to be regarded as income

accruing to the taxpayer after 1913. Respondent correctly says that the decision was that the taxpayers' relation with the subsidiaries was such that the income accrued to the former before the 1913 tax date. Just why this distinction affects the validity of these precedents is not apparent. The pre 1913 income of the Central Pacific was none the less income because when earned it was not subject to tax. The assimilation of the income to the Southern Pacific had no income tax consequence because there was no income tax law at the time; but the decision in the *Southern Pacific* case was that what was in form (prior to 1913) Central Pacific's income was in fact Southern Pacific's. Anyone familiar with the history of the Southern Pacific and the Central Pacific knows that the activities of the Central Pacific (even though it had no bank account and was completely dominated by the Southern Pacific) were far more substantial in character than those of the present petitioner. For example, it is a matter of history that the Central Pacific Railroad Company, the western end of the first trans-continental railroad, received a heavy loan of United States bonds, which constituted a second mortgage on most of the line between Ogden and San Francisco.[1] These bonds matured, together with very heavy accumulated back interest, during the financial storm of the 90's. A refinancing arrangement was made under which the Central Pacific's debt to the Government was extended over a period of ten years.[2] In addition, the Central Pacific had outstanding other corporate obligations in the form of various bond issues. Further, respondent's argument ignores the fact that post-1913 dividends from pre-1913 earnings were held taxable at the same time that the *Southern Pacific Company* decision was announced. *Lynch* v. *Hornby*, 247 U. S. 339, 38 S. Ct. 543, 62 L. Ed. 1149. There is no substantial

1. Daggett, History of the Southern Pacific, Ronald Press, New York, 1922, pp. 51-54.

2. *Ibid*, pp. 417, 423.

distinction, so far as the point here involved is concerned, between the *Southern Pacific Company* case and the present one.

Respondent says (Brief, p. 19) that a literal construction of Section 13 is not "productive of injustice or oppression," and that the provision for taxation "is there for all to heed as an incident to incorporation for business ventures." However pertinent such an argument may be in some situations, it is clearly inapplicable to the circumstances under which the present petitioner came into existence. Thompson had nothing to say about it except to determine whether he would accede to the arrangement demanded by an insistent creditor or accept the loss of his property. Respondent's statement of facts treats the demand for the organization of the corporation as something that was "proposed and agreed" (Brief, p. 3); whereas the fact is that it was a result of the creditor's demand and Thompson's enforced acquiescence. There was no "elaborate precaution" taken by Thompson "to relegate his interest in the property sold to that of stockholder rather than principal" (Brief, p. 24). The facts repel the inference that Thompson was interested in forming the corporation for the conduct of business as principal.

The relationship which came into being when Moline was organized was obviously a fiduciary relationship so far as was concerned any equity after the indebtedness. The rule is familiar that a conveyance which is absolute in form may be shown by extrinsic testimony to constitute a mortgage, so that the grantor may assert an equity of redemption. If Thompson had conveyed the land to the corporation by deed absolute in form (as was done in this case) but the stock, instead of being issued to him and transferred to the bank under a voting trust, had been issued directly to the bank, and the bank had later

asserted or caused Moline to assert that the conveyance included Thompson's entire interest, legal and equitable, in the land, it would have been open to Thompson to assert his beneficial interest in the equity and on paying the debt to have compelled a reconveyance to him.[1]

The formal issuance of the stock to Thompson and its conveyance by him to the bank under the voting trust arrangement cannot change the fact that Moline took nothing more than the naked legal title by the arrangement. The conveyance having run to Moline, no doubt a bona fide purchaser could rely upon the record; but no question is involved here of any estoppel in favor of a bona fide purchaser. The reason for the creation of the corporation was because the bank, for the ostensible purpose of strengthening its security, and doubtless because enforcement of its creditor rights seemed to it easier against a corporate holder of the title, demanded its creation. As respondent says (Brief, p. 22), when the corporation was first organized Thompson had no control over it, a fact which of itself demonstrates the unfairness, at least in the present case, of the argument (Brief, p. 19) that the corporate tax provision "is there for all to heed;" but he did have a very clear right in equity to enforce, upon payment of his debt, a return of his property. He was not in 1933 at the termination of the voting trust "simply in the position of a person taking over the stock of a corporation already organized and functioning." (Brief, p. 22) He was a person who had a right in equity to compel the bank to return him his collateral. If the bank had exercised its voting trust control in fraud of Thompson's rights to obtain for Moline, and through Moline for itself, the beneficial interest in this land, a

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1. Authorities are numerous which sustain the proposition stated in the text. Florida has the same rule. *De Bartlett* v. *De Wilson*, 52 Fla. 497, 42 Sou. 189, 11 Ann. Cas. 311.

court of equity would upon application by Thompson have made it clear that Moline's naked legal title did not include the beneficial interest, and that, as the Board of Tax Appeals held, the beneficial interest was in Thompson. This being the situation during the time of the bank's voting trust control, the relationship between the corporation and Thompson did not suddenly undergo a change when Thompson regained the stock control. The agency-fiduciary relationship existing at the conclusion of the voting trust was not altered. The return of the stock did not rise to the dignity of a conveyance to Moline of the beneficial interest. The corporation remained absolutely inactive. It performed no function other than that of a naked legal title holder after 1933 as well as before.

Whatever advantage there may have been to Thompson in the forming of the corporation as a means of salvaging something from his losses and protecting his equity, that purpose had been accomplished after 1933. There was absolutely no business reason for the continued existence of the corporation. Thompson could derive no advantage from it. His conduct in reference to his other holdings indicates that no purpose would be served by the corporate form. The most reasonable explanation for Thompson's omission to take steps to reacquire the formal legal title is inertia. His and his auditor's unfamiliarity with the tax laws led to reporting the gain, in 1934 and 1935, as the taxpayer's gain.

While everyone is presumed to know the law and no one can plead ignorance of the law to avoid the legal consequences of any particular situation, yet actual ignorance of the law applicable to a particular situation is relevant upon the question of intent. In the present case the record discloses that both the auditor and Thompson were ignorant of the *Forshay* decision, 20 B. T. A. 537, and the rule so often followed by the Board of Tax Appeals and other

tribunals with respect to dummy corporations holding title to property in which the beneficial interest is in another. The Federal Revenue Laws themselves do not hold any taxpayer irrevocably to a position once taken by him in his income tax returns, but, on the contrary, provide for liberal readjustments of income tax returns, both in favor of as well as against the taxpayer. The 1934 and 1935 returns made in ignorance of the taxpayer's and Thompson's rights raised no estoppel against showing the true facts. Whatever force the making of these returns may have had as evidence tending to show beneficial interest in the corporation is completely negatived by the circumstances surrounding the making of these reports and Thompson's and the auditor's ignorance of the doctrine applicable to dummy corporations. At the very most, this circumstance only raises a conflicting inference which the decision of the Board of Tax Appeals has resolved in the taxpayer's favor.

Respondent makes some reference to activities of the corporation, both before and after 1933. In the statement of facts respondent recites (Brief, p. 5), very briefly, that on October 1, 1929 the taxpayer purchased from Biscayne a note of Thompson's with a mortgage securing it in the amount of $43,000, on which interest of $9,703.14 was due, at par plus interest, giving its note for the purchase price and securing it with Thompson's mortgage. Just what is the purpose of this recital is not apparent; for it refers to the fraudulent transaction explained on page 5 of the original brief herein. The statement of facts also refers (Brief, p. 6) to the 1934 lease for parking lot purposes, in which connection respondent says that "it (the petitioner) received rental of $1,000." Reference is again made in the argument to this matter, in which connection respondent says (Brief, p. 22) that "in 1934 it (the petitioner) received income from renting a portion of its property." In thus assuming the very question here in issue, respondent also ignores the fact that the testimony permits of no

inference other than it was Thompson, not the taxpayer petitioner, that actually received this income. Any doubt on this subject is resolved by the Board's factual determination in favor of the taxpayer.

Respondent's argument in effect is that the fact of an agency or fiduciary relationship, although given effect in any other situation, may not as a matter of law ever be shown where the principal or party beneficially interested is also the sole stockholder of the agent or fiduciary. Although no attack is made on the *Southern Pacific* and *Gulf Oil Corporation* cases (which respondent himself at times cites[1] in converse situations), it is frankly contended that the "body of law" referred to in the *Brager* case, 124 Fed. (2d) 349, is wrong. Such decisions respondent says (Brief, p. 29) are based upon a "misconstruction of *Southern Pacific Company* v. *Lowe.*" The fact is, however, that respondent's position cannot be reconciled with the *Southern Pacific Company* case. While that case does not lay down any general rule favoring disregard of corporate entity, it did decide that in determining whether income is that of one entity or the other the decision is not to rest upon a mere rule of thumb, in accordance with whatever may appear to be the formal situation. Two things stand out prominently in the *Southern Pacific Company* decision, namely, that actualities are to govern, and that this rule works both ways.

In the present case if it had been to the advantage of the Commissioner that the gain from the sale of these lots be taxed to Thomposn, it is not unlikely that the converse argument would be made upon the same record as that here presented. In the absence of some element of tax avoidance, common fairness demands that substance

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1. For example, in his brief in this Court in *Higgins* v. *Smith*. The petitioner's reply brief in the *Interstate Transit Line* case, docket No. 552, sets out in the appendix some excerpts from that brief.

and not form, reality and not unreality, be the governing principle in determining which of two entities, corporation or the stockholder, is beneficially entitled to the income to be taxed. A recognition of actualities involves no difficulty of administration. In the routine handling of the examination of income tax returns the inquiry is normally directed to the ascertainment of the facts of any particular transaction. Respondent himself insists upon a full inquiry into the facts where it is the taxpayer that relies upon the form. The burden of an examination of the facts and reaching a decision based upon actualities is no greater when this assists the taxpayer than in the converse situation.

The record makes it plain that the present case is one of great hardship, if the decision of the court below is upheld. While this circumstance alone is not controlling, yet it does suggest that the harsh result of enforcement against petitioner (which as a practical matter means against Thompson, as transferee) of the tax asserted by respondent should not be tolerated unless absolutely compelled by law. Lower tribunals have in a considerable number of cases rejected the harsh and one-sided argument advanced by the respondent. Until very recently the Board of Tax Appeals, as its own opinion in the present case says, consistently followed the view urged by the present petitioner. This rule is consonant with justice and fairness. Respondent's argument rests upon a narrow and technical interpretation of the law, and upon exalting form above substance. It is earnestly submitted that this argument runs counter to the spirit of modern decisions, and that the contrary view expressed

in authorities giving the taxpayer relief under such situations should be adopted, and the decision below reversed and that of the Board of Tax Appeals reinstated.

Respectfully submitted,

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